An Overview of UK Retail Financial Scandals in recent decades: Uses and abuses of Behavioral Finance.

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Abstract

Instances of banks and other financial services companies taking advantage of the cognitive limitations and biases of their retail customers have been numerous and sometimes extremely significant in recent decades. For example, some of the major scandals, which have each resulted in billions of pounds of compensation to customers, have involved the mis-selling of personal pensions, with profit-endowments and PPI policies and there have been numerous other instances of consumer protection issues.

Some scandals have resulted in regulatory action such as the regulators setting specified rates of return to use in investment projections. However, specific concerns are still been raised by regulators (e.g. the FCA), charities and consumer bodies in the UK that factors relating to suboptimal behaviour by consumers relating to issues such as consumer inertia, unfair cross-subsidies, add-on goods and product complexity may lead to poor financial outcomes for those consumers.

This paper gives an overview of the nature of these events with a particular emphasis on the behavioral issues involved. It considers the extent to which institutions can and have exploited their customers, whether customers can be educated or ‘nudged’ into different behaviors and the role of the regulators in preventing future problems.

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1. Introduction
Instances of banks and other financial services companies taking advantage of the cognitive limitations and biases of their retail customers have been numerous and sometimes extremely significant in recent decades. For example, some of the major scandals, which have each resulted in billions of pounds of compensation to customers, have involved the mis-selling of personal pensions, with profit-endowments and PPI policies and there have been numerous other instances of consumer protection issues.

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This paper gives an overview of the nature of these events with a particular emphasis on the behavioral issues involved. It considers the extent to which institutions can and have exploited their customers, to what extent well-established behavioural biases are responsible for the problems, whether customers can be educated or ‘nudged’ into different behaviours and the role of the regulators in preventing future problems.

Initially section 2 discusses the relevant theoretical issues. Section 3 presents case studies about some of the main scandals that have occurred and how they connect to the theoretical issues presented. Section 4 presents conclusions.

2. Theoretical Issues
The theoretical issues involved touch on a number of literatures which sometimes indicate different conclusions. For convenience I have set our broad summaries of some of the relevant literatures below:

2.1 Neo-classical economics and regulatory responses.
The view of free market economists is that individuals are the best judges of their own requirements and utility and should be as free as possible to make their own decisions (see, for example, Dowd,
1996). Even though all the parties involved in transactions will act to further their own interests, individuals will be able to act to ensure they are not exploited by financial institutions.

Various issues have been raised with the reasoning above. There are issues with asymmetric knowledge and information whereby individuals clearly have less information about the specialised products involved than the financial companies with which they are dealing (Llewellyn, 1999). Relevant to this there is a substantial literature on financial literacy which tends to indicate that many people have questionable financial knowledge and are unlikely to be able to make sensible decisions in this domain (see, for example, Gathergood, J. and Disney, 2011).

Financial product providers design products and their distribution (sales) strategy to maximise profits. Their objective of profit maximisation may not necessarily coincide with the interests of the customers. Both product design and the way they are sold are of key importance in this industry. In the UK experience, commission and financial incentives have been extensively used to incentivise salesmen and other intermediaries to sell products.

There have been particular issues with independent financial advisors in the UK. Broadly these should work in the interests of the consumer but this has not always been the case given their incentives from the financial companies creating the products.

Given the above and the fact that many of the relevant products are of great importance to individuals there is a clear argument that the industry should be regulated to protect consumers to a greater extent than other industries and this has been broadly accepted in the UK with a key piece of relevant legislation being the Financial Services Act, 1986 (Barnard, 1987).

2.2 Behavioral Biases

It is well known in the economics and financial literature that people have behavioral biases and often make decisions they are not entirely logical. Many of these biases are very well established. The question is whether these can explain the mis-selling episodes. Is it the case that they can explain the way that the way that the products have been designed or sold and the way the public has reacted to the products? The main biases which seem particularly relevant to the mis-selling episodes are briefly outlined below:

i) Hyperbolic discounting is a time-inconsistent model of discounting future events (Laibson, 1997). It differs from rational exponential discounting and tends to result in impulsive actions which excessively prioritise the short term.

ii) Availability bias is the idea that individuals will place more weight on examples that can be immediately brought to mind (Tversky and Kahneman, 1973).
iii) Anchoring bias is a bias whereby individuals are heavily influenced by a particular, possible irrelevant, reference point (Tversky and Kahneman, 1974).

iv) Salience bias refers to tendency of individuals to focus on elements of a situation that are more prominent or emotionally powerful even if these are not of greater relevance or importance. The bias is closely related to the availability bias (Thaler and Sunstein, 2009).

v) Mental accounting refers to the finding that people do not treat money as fungible but instead tend to compartmentalise into between different mental accounts (Thaler, 1985).

vi) Representative bias refers to the mis-conception that because something is more representative it is more likely (Tversky and Kahneman, 1974).

vii) Loss aversion, which is related to prospect theory (see, Kahneman, and Tversky, 2013), refers to the tendency of individuals to prefer to avoid losses rather than make equivalent gains.

2.3 There is a literature on how individuals interact with advisors although little of this covers the finance area (a good summary of this area is in Ayton et al, 2021). We discuss the extent to which the dynamic between individuals and their advisors, perhaps combined with behavioural biases, can explain the mis-selling issues.

3. Case Studies

3.1 Pension Mis-selling

3.1.1 Events

The Conservative government of Margaret Thatcher which was elected in 1979 had a strong liberalising agenda which extended to financial services. The Social Security Act of 1986 liberalised the pensions market with the aim of allowing and encouraging greater personal control and responsibility for pension provision (Burton, 2018). One important aspect of the changes introduced by the act was that individuals were allowed opt out of membership of a collective occupational pension scheme in favour of their own personal pension. Furthermore, they could transfer a lump sum representing the value of the benefits they had accrued in occupational pension schemes into their personal pension. Such transfer values were often very significant as a proportion of individual’s total wealth.

At the time many individuals were in defined benefit occupational schemes where the benefits payable were based on the salary of the individual involved rather than on investment returns over their lifetime. In addition, the employer would normally contribute substantial sums in excess of members’ salaries to ensure that the promised pensions would be paid. In contrast, employers would not normally contribute
to personal pensions and the ultimate benefits from such pensions would depend on future investment returns.

It is now clear that individuals transferring out of defined benefit occupational schemes were generally very unlikely to benefit from such a transfer as implausibly high investment returns would be required for them to receive higher pension benefits. Nonetheless, such transfers were conducted in very large numbers with financial advisors and insurance company representatives routinely recommending them. Often such recommendations were no doubt swayed by the large commissions payable to the advisors if they went ahead.

Over the next few years it became increasingly apparent that many personal pensions had been mis-sold. Eventually, there was a very prolonged and complex exercise to compensate the individuals involved and the cost of this was estimated at approximately £12bn in 2002 (Financial Services Authority, 2002).

After this episode the regulators clamped down on the ability to take transfers out of defined benefit schemes by placing very onerous requirements on financial advisors to justify any such transfers as being in the interest of their client. Given that clients may claim compensation if it transpires that transfers result in a bad outcome and were not fully justified almost no advisors will now transact such business.

3.1.2 Theoretical Implications

One might consider how advisors were able to persuade individuals to act against their own interests and by transferring into personal pension schemes in such a way. Clearly, an important factor would be the fact that advisors would be regarded as trusted experts in a complex field where most individuals would have very little expertise.

However, advisors would still need to offer a plausible story to support their advice and it is interesting to consider whether these are in accordance or even in contrast to the biases typically outlined in the behavioural finance literature. Some particular biases are considered below:

i) Hyperbolic discounting or high rates of discounting would indicate that people are unlikely to be very interested in pension payments many years in the future. This actually is very much in accordance with received wisdom in the financial services industry that ‘pensions have to be sold not bought’. There are two somewhat contradictory implications of this: people may not be interested in any interaction with advisors regarding pension contracts or alternatively they may have sufficient interest to interact but not too concerned about the details which would facilitate mis-selling.
ii) Availability bias - generally customers will have had very little relevant information available to them. The advisor will have been able to control what was supplied and make sure that it presented the transfer in a favourable light.

iii) Anchoring bias – the advisor would be able to show good recent returns as an indication of what could be expected as a return on the investment.

iv) Salience – at the time the government was strongly promoting a political agenda of taking individual control over their own finances and transferring to a personal pension was very much in line with that concept.

3.2 Endowment Mis-selling

3.2.1 Events

Before the mid-1980s most British consumers repaid their home mortgage loans using a conventional repayment mortgage where the repayments covered both the interest on the loan and an appropriate proportion of the capital such that the loan would be repaid by the end of its term. In the late-1980s it became very popular to start to repay mortgages using low cost endowment policies and at the peak of their popularity in 1988 they captured 83% (Severn, 2008, p6). Low cost endowment policies were insurance policies which produced returns based on returns in the financial markets particularly the equity markets. There was a risk that if investment returns were not sufficiently good the maturity value of the policy would not be sufficient to repay the loan. Generally, when the endowment policies were sold very little emphasis was put on the possibility that the loan would not be repaid and instead the likelihood of the loan being paid off with a very large surplus was stressed as a selling point. Often projected returns were based on returns in the previous decade which had been extremely high and were unlikely to be repeated in the future. In addition, the projections often did not incorporate sufficient allowance for the charges on the policies. As time progressed and the performance of the stock market was not as good as projected it became clear that many of the endowment policies would not return enough to repay the associated loans. A long and complex legal and regulatory battle ensued with 1.8 million complaints being made and over £2.7 billion paid in compensation by July 2007 (Severn, 2008, p5).

The outcome of this episode was that the regulator insisted that in future all investment projections for pensions and insurance policies had to be done on conservative rates that it mandated from time to time based on then current market conditions\(^2\). The projections also had to incorporate the actual charges on

\(^2\) See FCA (2017) for the latest analysis of the issue by the regulator.
the policies. These changes in conjunction with the bad publicity the scandal had created effectively destroyed the market for these products.

3.2.2 Theoretical Implications

In many respects the theoretical implication of discounting, availability and anchoring biases and salience are quite similar to those discussed above for personal pensions. The particular nature of low-cost endowment policies will also have mean that prospect theory probably was quite important. Low cost endowments provided returns that were broadly linked to those on an underlying fund invested in equities, bonds and property although the insurance company would smooth the returns over time. Importantly, the policies had guaranteed minimum maturity values which would be an attractive feature given that people tend to be more influenced by losses than by gains.

3.3 Payment Protection Insurance

3.3.1 Events

Payment Protection Insurance (PPI) is insurance used to protect the repayments of individuals who have taken out loans. The loans could be unsecured personal loans or loans secured against property such as mortgages. The PPI policies would insure that payments on the loan would continue to be met in the event of specified contingencies such as accident, ill-health or unemployment. By 2006 in was estimated that 20 million PPI policies were in operation in the UK (Office of Fair Trading, 2006). There were long standing concerns about the way these products were sold, the protection they provided and their value for money with numerous investigations by UK regulators and by their oversea counterparts (see, Ashton and Hudson, 2014). In January 2009, the joint sale of credit and PPI insurance was prohibited by the UK competition law judgement body, the Competition Commission after 2010 (Competition Commission, 2009). Firms were also obliged to compensate customers where PPI was or was perceived to be mis-sold. The total claims from this mis-selling have been extremely substantial and by December 2019 the amount paid in compensation was £38.3 billion (FCA, 2021).³

3.3.2 Theoretical Implications

Probably the main issue leading to mis-selling cases was some type of assumptive selling process, This is a form of selling where firms present the acceptance of both the loan and PPI as the norm so that customers would have to explicitly reject the purchase of the PPI contract (FSA, 2007). As a result of this customers were often sold policies that they did not really want, were not suitable for their

³ The total cost of mis-selling PPI has not been calculated by the FCA after December 2019 due to the Covid-19 pandemic.
circumstances and overpriced. To a large extent the mis-selling was probably enabled by customers having excessive trust in the advisors however some recognised biases were also in play:

i) Salience – customers would have primarily been interested in the underlying loan rather than the PPI policy so the terms and conditions of the latter would have been of relatively little interest.

ii) Availability bias - generally customers will have had very little relevant information available to them. The advisor will have been able to control what was supplied and make sure that it presented the transfer in a favourable light.

One well recognised bias that would seem to perhaps go against the mis-selling of these policies is mental accounting which would tend to indicate that customers might tend to mentally segregate the money used for the PPI policy from that used directly for the loan which would tend to break the link between the two desired by the advisors during the selling process.

3.4 Inertia in financial services products.

3.4.1 A currently controversial issue in financial services is the use of customer inertia by financial services companies to extract value from their customers. In this approach, customers who do not frequently check the market to ascertain the best deals being charged more or given worse benefits than customers who do move providers. This issue is evident in various markets from bank deposit accounts (Anderson et al, 2014; FCA, 2018a; FCA, 2018b, FCA, 2020a) to many insurance products (Citizens Advice Bureau, 2018; FCA, 2020b). The amounts that customers are losing because of these practices are substantial. The FCA has recommended reforms to bank deposit accounts such that the rates on all old accounts revert to a reasonable rate which would save bank customers of the order of £300 million per annum (FCA, 2020a). Similarly, the FCA has recommended major reforms of the pricing of home and motor-insurance, so that existing customers are not charged more than new customers and has estimated a benefit to customers of this policy of about £1.2 billion per annum (FCA, 2020b).

3.4.2 Theoretical Implications

This area of financial services differs from the other areas discussed above in that the action or persuasion of intermediaries does not play a part. The financial services instead rely on the inertia of their customers although the firms not play an active role in frequently designing and marketing new products to non-existing customers or alternatively market existing products at lower prices to new customers.
Customer inertia does not seem to be a well-recognised bias in the finance literature. Rational economic theory would suggest that individuals will weigh up the value of the time they would spend reviewing the market against the benefits of changing product and this would indicate a certain rational level of inertia although not sufficient to explain what is observed in many markets. Anderson et al (2014) provide a model allowing for a higher and irrational level of inertia by assuming that individuals discount the benefits from moving at a high rate using hyperbolic discounting. Other models could, no doubt, be developed to explain inertia effects.

4. Conclusions

We can consider what can generally be conclude from the attributes of the different situations above. In all the cases the customers involved have acted in a way against their own interests. In a sense this can be considered irrational almost by definition. In the complex situations that occur in financial services advisors are in a powerful position. Initially, they are generally far more knowledgeable than their customers in the relevant areas and will have a high general of influence as expert advisors. Secondly, they set the agenda and the terms in which the problem and solution are presented and thus can do so in a way that uses relevant biases to further their aims.

Biases seem to have contributed to problems but much less so to solutions which have generally been through the medium of hard regulation or legislation. Thus, ‘nudges’, to the extent they have appeared, seem to have been a rather negative force in this area.
References


